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CHINA'S TRADE WAR SCENARIOS AND INVESTMENT OPPORTUNITIES

Spotlight

Global Investment Committee

UBP
Union Bancaire Privée

Key points

- *Our Base Case Scenario calls for compromises between the US and China in the run-up to the US Congressional elections in November*
- *Even under our Risk Scenario, Chinese banks should be the biggest beneficiary of countercyclical Chinese policy in early-2019*
- *China USD sovereign and investment grade credits continue to trade richly with China USD high yield presenting better relative value*
- *Our outlook for the Chinese Yuan is for stability in our Base Case Scenario though the prospect for a more meaningful weakening exists under our Risk Scenario*

Sino-US trade tensions continue to dominate the focus of global markets with few signs of resolution in the near term. To assess this highly tenuous development, we have constructed a two-scenario trade war framework. Our Base Case Scenario (A) is that the trade war will be contained with a compromise between Beijing and Washington struck in the run-up to the US November mid-term elections. In response, China's current policy easing will scale back in early 2019 and its policy focus will return to structural reform later in the year. The Risk Scenario (B) that anticipates an intensified trade war between the two countries and hostility prolonged well beyond the US mid-term elections. To fight growing downside risks to growth, China is expected to scale up its retaliation and reflation measures, cushioning near-term growth prospects but raising risks of medium-term economic disruption if those measures become extreme. We detail the scenarios below as well as the implications for major asset classes in China under each outcome.

Base Case (A) Scenario:

- US imposes a 25% tariff on a total of USD 250 billion of Chinese exports to US. Direct impact (other things being constant) trims China's GDP growth by about 0.8% points (inclusion of multiplier effect) to about 6% year-on-year in one year (from current 6.8%). China's countercyclical policy can still be quite measured to fight a relatively modest downturn without risking serious re-leveraging problems.
- **Policy response** – measured liquidity injections via reserves requirement ratio (RRR) cuts, targeted lending, easing of financial regulations on some shadow credits combined with fiscal measures including tax cuts and incentives to consumers and corporates especially on R&D and technological development.
- **FX policy** – The framework to assess the exchange rate in this scenario is that, if the People's Bank of China (PBOC) wants to purse a competitive devaluation policy to 'fully' offset the 25% tariff on USD 250 billion, the yuan will need to depreciate to about 7.30 to USD (from its current 6.84). The current FX market is pricing in an approximately 40% probability of that outcome. However, if trade war pressures do not escalate, we expect USDCNY to re-establish a trading range of 6.50 to 7.00.

Risk (B) Scenario:

- Escalated trade tension results in all China's USD 450 billion exports to the US being subjected to a 25% import tariff. China's GDP growth could be cut by some 1.4% points to about 5.5%. The scale of China's reflation will therefore need to step up significantly to fight the potential headwinds.
- **Policy response** – monetary expansion may resemble the scale seen during the 2012-13 policy easing with total credit growth reviving to 15-16% year-on-year (from its current 10%), backed by a further 200-300 bps cuts in RRR and sizeable targeted lending to support infrastructure investment, the corporate and household sectors and, possibly, the housing market. Monetary easing will also be accompanied by more aggressive fiscal measures potentially in the form of a mini- stimulus programme as well as aggressive tax incentives provided to boost home-grown technology for the government's all-important 'China 2025' plan.

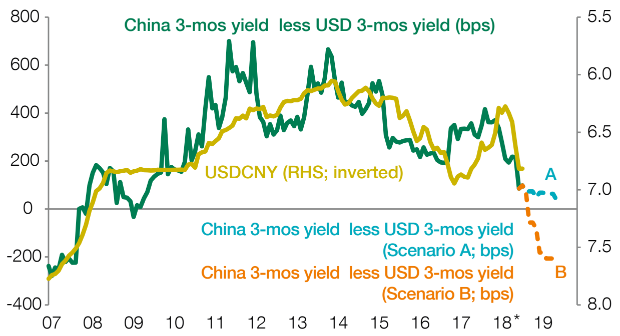
Tariff Impact and Growth Scenarios

	Tariff Value (USD bn)	Tariff Rate (%)	Impacted Value (USD bn)	Cut to China Export Growth (%)	Cut to China GDP (%)	Multiplier Effect (1.5X)	Total Cut to China GDP (%)	GDP Growth (YoY) 1H/18 6.8%
SCENARIO A (BASE CASE)								
First Strike	50	25%	12.5	-0.6%	-0.1%		-0.2%	6.7%
Second Strike	200	25%	50	-2.2%	-0.4%		-0.6%	6.2%
Total	**250**		**62.5**	**-2.8%**	**-0.5%**		**-0.8%**	**6.0%**
SCENARIO B (RISK CASE)	**450**	**25%**	**112.5**	**-5%**	**-0.9%**		**-1.4%**	**5.4%**

Source(s): Bloomberg Finance L.P.

- The real concern here is that if any trade war extends into non-trade retaliations (e.g. curbs on foreign investment, tourism, etc.), and China's downside economic risk becomes amplified, it will increasingly present a tough balancing act for Beijing between protecting growth and not risking another round of major debt accumulation and, likely, major economic imbalances further down the road.
- **FX policy** – 'Full' offset of 25% tariff on USD 450 billion exports to US requires CNY to depreciate to around 8.00 against USD (from its current 6.85). Depreciation risk increases significantly in this Risk Case Scenario. Also, interest rate differentials between CNY and USD will narrow significantly and may even turn negative in the event of a more aggressive monetary easing in China against continued US Fed tightening.

CNY under added pressure from monetary easing



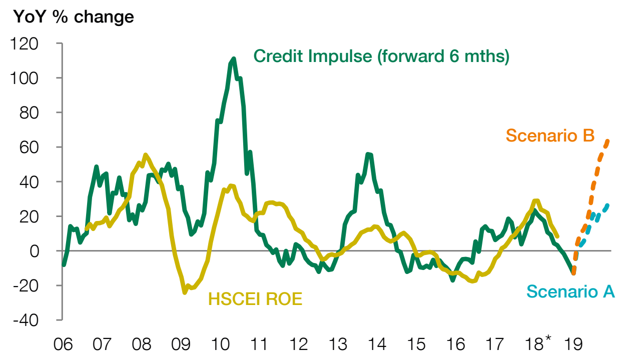
Source(s): Bloomberg Finance L.P., UBP

Investment Strategy

Equity

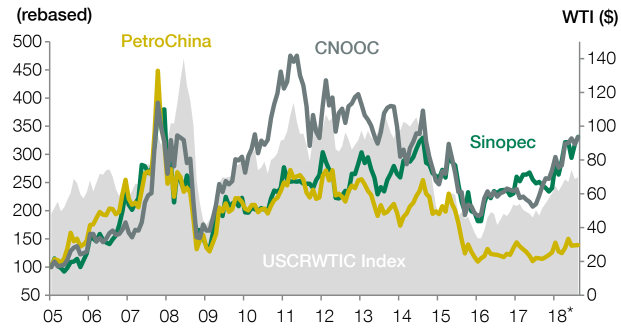
Both Scenario A and the early stage of Scenario B should create a tactical entry opportunity into Chinese equities in the months ahead after an over 20% sell-off in the broad market from this year's peak level and an expected bottoming and rebound in economic growth moving into 2019. This rebound in growth driven by policy stimulus should drive cyclical ROE expansion and earnings acceleration among Chinese banks in early-2019. This leaves Chinese banks as the most attractive large cap beneficiary under both trade scenarios outlined. In particular, loan book expansion will benefit large banks while improved liquidity and, thus, lower interbank rates, will enhance smaller banks' net interest-rate margin as funding cost declines.

HSCEI ROE and China's credit impulse



Source(s): Bloomberg Finance L.P., UBP

China energy share prices vs. WT



Source(s): Bloomberg Finance L.P., UBP

We also think that the Hang Seng China Enterprise Index (HSCEI) is better positioned relative to MSCI China to benefit from the policy responses to the current trade conflict given its substantial weighting towards China's domestic sectors. For instance, 63% of the index weighting relates to Chinese financials, 13% to energy and 3.7% and 3.6%, respectively, to Tencent and China Mobile. Energy stocks are largely driven by global oil prices while Tencent's ROE is influenced more by China's own regulatory policy and economic cycle.

Valuation has the HSCEI currently trading at 0.96x PBV which is about a 11% discount to the average since January 2013, and almost one standard deviation below its 5-year average, leaving attractive risk/reward especially under Scenario A, where the trade conflict is not expected to be protracted.

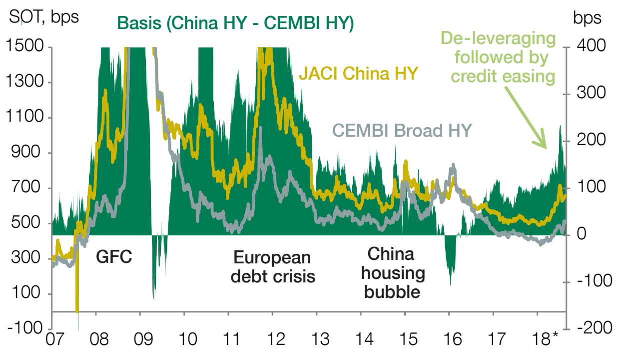
The historical lowest PBV occurred in January 2016 during China's previous housing bubble and sustained CNY depreciation when PBV declined to two standard deviations below the 5-year average. Using this as our valuation yardstick, a further 19% decline of the HSCEI index from its current 10560 level will take PBV down to below a two standard deviation level (PE will decline to 6.5x from the current 7.9x) which should provide an attractive entry point (from a historical valuation point of view) to compensate for the bigger risk as mapped out under Scenario B.

China USD credit

China's USD sovereign and quasi-sovereigns remain rich despite the trade war risk and the global sell-off in emerging market bonds. Better value can only be found in China USD high yield credits which are currently trading at 650 bps over US Treasury yields and 150 bps above yields on the J.P. Morgan Corporate Emerging Market Bond Index. In fact, the China high yield spread has already tightened since their peak in June 2018 as China began easing monetary policy and previous harsh de-leveraging targets were softened.

We expect that China's HY credits will continue to benefit from further monetary easing but will become cautious on the sector in Scenario B, should China's reflation policy becomes overly aggressive. This may either rekindle market concern about significant re-leveraging being followed by another clampdown and credit defaults, or negative rating action by rating agencies as an asset bubble risk resurfaces.

JACI – Better compensated in high yield



Source(s): JP Morgan, UBP

* 2018 data through 27 August 2018

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